In the Supreme Court of the United States

OCTOBER TERM, 1974

NO. 73-1657

ESTATE OF JOSEPH M. MEADE, ETC., ET AL.,
PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

MEMORANDUM FOR THE RESPONDENT IN OPPOSITION

In connection with the prosecution and settlement of an antitrust claim previously held by their liquidated corporation, petitioners made cash disbursements for legal expenses. At the time of the liquidation, the antitrust claim of the corporation was distributed to petitioners who, as shareholders, thereby acquired ownership of the claim. Pursuant to Section 331 of the Internal Revenue Code of 1954, which treats the proceeds of a corporate liquidation as received in exchange for the surrendered stock, petitioners were entitled to report the gain realized from the settlement as long-term capital gain.

The sole question raised by the petition is whether the legal expenses incurred by petitioners in prosecuting and settling the antitrust claim were deductible

from ordinary income as expenses incurred "for the * * * collection of income" under Section 212(1) of the Code, or whether those expenses must be capitalized and offset against the long-term capital gain realized by them. The court of appeals held that petitioners' recovery upon the claim constituted, for income tax purposes, additional consideration for their stock surrendered in the corporate liquidation thereby giving rise to long-term capital gain.[1] It therefore concluded that the related legal expenses were incurred in connection with the disposition of petitioners' stock, a capital asset, and must be capitalized in accordance with this Court's decisions in *Woodward* v. *Commissioner*, 397 U.S. 572, and *United States* v. *Hilton Hotels Corp.*, 397 U.S. 580.

1. Petitioners principally argue (Pet. 4-8) that the court of appeals misapprehended the "origin of the claim" test which was formulated by this Court in *United States* v. *Gilmore*, 372 U.S. 39, and applied in the *Woodward* and *Hilton Hotels* decisions. They urge that the decision below conflicts with the latter cases.

As applied in *Gilmore*, the "origin of the claim" test was intended to obviate the need to ascertain the primary purpose of a taxpayer's litigation expenditures. There, the taxpayer urged that his legal costs incurred in defense of a divorce action were motivated primarily by his concern that he would lose income-producing property and that his business reputation might be damaged by an ad-

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[1]Because the antitrust claim had no ascertainable fair market value at the time of the liquidation, the transaction remained "open" for tax purposes. See *Commissioner* v. *Carter*, 170 F. 2d 911 (C.A. 2), and *Westover* v. *Smith*, 173 F. 2d 90 (C.A. 9). The parties are agreed that the proceeds of the claim constituted additional consideration for the stock surrendered in the liquidation and were taxable as long-term capital gain.

verse decision. The government, on the other hand, took the position that the costs of the taxpayer's divorce litigation were essentially personal expenses which were nondeductible under the predecessor of Section 262 of the 1954 Code. In upholding the government's contention, this Court refused to delve into the taxpayer's subjective motives to resolve the question whether he was concerned primarily with personal or business consequences of the divorce action. Because the claim arose out of his marital relationship, the costs of defending the claim were held to be personal, without regard to possible business related consequences.

In further application of that principle, the Court in *Woodward* and *Hilton Hotels* rejected the similar argument made by the taxpayers in those cases that appraisal costs incurred in connection with the acquisition of dissenting shareholders' stock were not incurred for the "primary purpose" of acquiring the stock but rather were incurred for another purpose which warranted current deductibility. Pursuant to this Court's analysis in *Hilton Hotels* and *Woodward,* the taxpayer's "purpose" in incurring such appraisal costs is irrelevant. Since such costs were expended in either acquiring or disposing of a capital asset, they were deemed to be "as much part of the cost of that asset as * * * the price paid for it." *Woodward* v. *Commissioner, supra,* 397 U.S. at 576.

Because the "origin" of petitioners' claim was the potential antitrust cause of action of their corporation, petitioners urge (Pet. 7) that an application of the "origin of the claim" test requires the conclusion that the legal expenses they incurred were for the collection of income and therefore deductible against ordinary income under Section 212. But the "origin of the claim" analysis of *Gilmore* does not, as petitioners argue, operate solely on the basis of the ultimate historical roots of the

claim. Under that analysis, petitioners' claim arose out of the corporate liquidation in which they received the claim in exchange for their stock. In petitioner's hands, the claim served to increase the potential amount of the proceeds of the liquidation. These objective circumstances control the characterization, for tax purposes, of the legal expenses incurred in enforcing the claims as capital expenditures.

Indeed, petitioners' emphasis on the historical roots of the antitrust claim implicitly suggests that they are entitled to the same ordinary deduction treatment that their corporation would have received had it incurred these costs in enforcing the claim prior to the liquidation. Such an assumption overlooks the decisive fact of the corporate liquidation. Prior to that event, the claim was a business property in the hands of the corporation, the recovery of which would have been taxable as ordinary income. The costs incurred by the corporation in seeking recovery of such an ordinary income item would have been deductible from ordinary income. However, once the corporation liquidated and distributed the claim to petitioners, it took on the nature of an investment or capital asset in the hands of the shareholders. The gain from the sale or exchange of a capital asset is taxable at capital gains rates and expenses incurred in such a sale or exchange are capital expenditures which can only be offset against the proceeds of sale. For purposes of the *Gilmore* test, the "origin" of the claim arose upon the liquidation of the corporation and receipt of the claim by petitioners as a capital asset. Accordingly, the court of appeals correctly concluded that the expenses thereafter incurred by petitioners were capital expenditures incurred in disposing of a capital asset, and

therefore could only be offset against the capital gains received by them from the liquidation proceeds.[2]

2. Petitioners further contend (Pet. 13-15) that the decision below is in conflict with *Commissioner* v. *Doering*, 335 F. 2d 738 (C.A. 2). There, the taxpayer owned 20 percent of the stock of a corporation which had contracted with a second corporation to produce certain films for distribution profits. A dispute arose between the two corporations as to the share of the distribution profits. Subsequently, the taxpayer's corporation was dissolved and he received an undivided share of the claim against the second corporation. Ultimately, the controversy was settled and the taxpayer received a cash payment, less his share of the attorneys' fees. On these facts, a divided Tax Court and a divided panel of the Second Circuit upheld the taxpayer's claimed deduction of the legal fees against ordinary income under Section 212. The court stated that

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[2]Petitioners' reliance (Pet. 6) upon a single sentence from *United States* v. *Hilton Hotels, supra,* is misplaced. In that sentence, the Court stated that "[t]he debts that Hilton inherited from Waldorf retained their capital or ordinary character through the merger, and so did the expenditures for fixing the amount of those debts" (397 U.S. at 585). This reference to the merger in *Hilton Hotels* appears to be based upon the fact that as a corporate reorganization under Section 368(a)(1)(A) of the Code, the merger did not occasion the recognition of any gain or loss and the tax attributes of assets and liabilities were carried over to the successor corporation which would operate the former separate businesses. Here, however, the gain from the corporate liquidation was recognized for tax purposes pursuant to Section 331(a)(1), and there was no carryover of tax attributes. Unlike *Hilton Hotels,* where the nature of the appraisal expenses remained unchanged before and after the merger, the claim in this case was transformed from a business property of the corporation to a capital asset upon distribution to the shareholders.

the expenses in question were not incurred in connection with the sale or exchange of a capital asset but were incurred in connection with the collection of the gain from the disposition of the taxpayer's stock (335 F. 2d at 741).

In our view, *Doering* cannot be reconciled with this Court's decisions in *Woodward* and *Hilton Hotels* and in effect has been overruled by those cases. The analysis of the Second Circuit, focusing upon the collection of the claim, closely follows the reasoning of *Naylor* v. *Commissioner*, 203 F. 2d 346 (C.A. 5), which this Court noted in *Woodward* (397 U.S. at 574, n. 1) was probably in conflict with its holding. Indeed, the conclusion in *Doering* —that the expense of litigation involving the ascertainment and collection of the price to be received for a capital asset is not a capital expenditure—is squarely contrary to *Woodward* and *Hilton Hotels*. And the court of appeals' statement in this case (Pet. App. A 29-30) that *Doering* was "considerably eroded by *Woodward* and *Hilton Hotels*" is supported by the weight of recent appellate authorities, which are contrary to *Naylor* and *Doering*. See, *e.g. Helgerson* v. *United States*, 426 F. 2d 1293 (C.A. 8); *Third National Bank in Nashville* v. *United States*, 427 F. 2d 343 (C.A. 6); *Munn* v. *United States*, 455 F. 2d 1028 (Ct. Cl.); *Lucas* v. *Commissioner*, 388 F. 2d 472 (C.A. 1).

Similarly, the apparent conflict in principle between the decision below and the cases cited by petitioners (Pet. 13), holding that legal expenses of a Section 337 liquidation are deductible, does not provide an adequate basis for review of this case. Apart from the fact that those cases do not present a conflict "on the same matter" within the meaning of Rule 19(1) of

the Rules of this Court, the conflict among the circuits as to the deductibility of the expenses of a Section 337 liquidation is diminishing in scope. Recently, the Fourth Circuit in an *en banc* decision in *Of Course, Inc.* v. *Commissioner*, No. 73-1495 (decided July 2, 1974), concluded that such expenses are not deductible. In so holding, that court overruled its prior decision in *Pridemark, Inc.* v. *Commissioner*, 345 F. 2d 35, and elected to follow the decisions of the Third, Sixth,[3] Seventh, and Eighth Circuits on the issue. Thus, the only remaining contrary authority is *United States* v. *Mountain States Mixed Feed Co.*, 365 F. 2d 244 (C.A. 10). Given the otherwise uniform line of decisions now holding that such expenses are not deductible, it seems unlikely that the Tenth Circuit would follow its prior decision.

For the reasons stated, it is respectfully submitted that the petition for a writ of certiorari should be denied.

ROBERT H. BORK,
Solicitor General.

SEPTEMBER 1974.

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[3]Despite the conflict of decisions on the question whether the expenses of a Section 337 liquidation were deductible, this Court denied certiorari in *Lanrao, Inc.* v. *United States*, 422 F. 2d 481 (C.A. 6), certiorari denied, 398 U.S. 928. The memorandum in opposition filed by the Solicitor General in that case acknowledged the existence of the same conflict asserted by petitioners here (Pet. 12-13), but opposed the granting of certiorari, stating (p. 3): "Nevertheless, it seems clear that this Court's decisions in *Woodward* and *Hilton* will have a considerable impact on the approach which will be taken by the lower courts in other cases in this area."